

# **Warning: There May Be No Government Solution to the Economic Crisis of 2008**

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**M**any Americans believe in fairies, magic wands, and Santa Claus. And they want to believe that their political leaders in the nation's Capitol – in both the outgoing and incoming administrations – have policy solutions, like rabbits pulled from hats, that will make the country's unprecedented economic troubles go away within the year, if not sooner. Not unexpectedly, the political rhetoric coming out of Washington amounts to lot of smoke and some mirrors.

The Bush and Obama teams have certainly solicited economic advice from the best and brightest of advisors, with everyone going before television cameras exuding considerable confidence that they understand the nation's and the world's economic problems at hand and, hence, know what will work – at least sort of.

Don't count on it. The credentials of the economic advisors in both the incoming and outgoing administrations are strong. They have lots of degrees and lots of experience in elite academies, financial markets, and Washington circles. However, we must remain wary of their ability to correctly diagnose and solve the current crisis for three overriding and powerful reasons:

- First, the current economic problems are indeed unprecedented. That means that theories and empirical findings on past economic troubles are poor guides for devising sound solutions to current problems. Diagnoses and orchestrated policy courses developed for the Great Depression, for instance, can be largely irrelevant and misleading when used as guides for today's problems.
- Second, our current economic problems are extraordinarily complex and global in scope, stretching from Wall Street in the United States to Main Street in Singapore. The effects of policy actions cannot be easily identified by, say, what happens to consumer spending or interest rates in the near term in the United States apart from the rest of the world. All policy actions – from bailouts to monetary expansions to stimulus packages – can have reverberating effects around the globe on indicators such as consumer spending and interest rates. Policy actions also may unintentionally draw resources away from alternative uses for these resources in ways that cannot be measured or reported.
- Third, current policy actions can affect people's expectations about the country's and world's future economic vitality in positive and negative ways. Changes in expectations cannot be easily assessed (if at all) because they are buried within the neural networks of hundreds of million of people in this country and billions of

people around the world. Yet the interconnectivity of the world means that positive or negative shifts in people's expectations can spread like a virus in ways that can easily overwhelm the analytical ability of even the brightest of policy experts.

- Fourth, at every turn, our political leaders' diagnosis of economic conditions and recommended policies will be clouded by information flows from powerful political lobbies (the domestic automobile industry, to use a prominent example) in Washington whose vested interests can grossly distort policy assessments of conditions and recommended solutions.

In light of the downturn in housing prices and the subsequent tightening of credit, the Federal Reserve admirably opened its monetary faucet to ensure that the country wouldn't repeat the events that followed the stock market crash in 1929. At that time, there were runs on banks and by 1933, a one-third reduction in the country's money stock, which sent economic activity into a tailspin from which it took the country years to recover. Now, with the Fed's target federal funds rate down to 1 percent, the economic correction the Fed can orchestrate is limited at best. Moreover, an ever more aggressive expansion in the country money supply to loosen lending and ignite consumer spending can give rise to expectations of higher inflation in the not-too-distant future. In turn, expectations of higher inflation can lead to higher long-term interest rates, dampening current long-term investment spending, especially since higher inflation rates can push people and corporations into higher tax rates.

Every time federal officials announce some new major bailout plans, journalists dutifully report how the federal dollars "injected" into the financial system will "unfreeze" the nation's and world's credit markets, which can give rise, as if by magic, to more lending and an economic revival. The journalists rarely report on how those bailout dollars are drawn out of credit markets, which means that the bailouts may do nothing more than redistribute credit, not increase the amount of credit to any substantial degree. Moreover, policy developers claim that the current economic mess is partially based on people's and banks' lost confidence in the future health of the financial system and economy, which suggests that their bailout plans can have only one effect, rebuild people's lost confidence. However, the dire economic warnings of pending economic calamity that accompanied bailout announcements can undermine some people's confidence in our economic future. This is especially true when the bailouts are focused on industries and groups of people (banks, automobile manufacturers, and borrowers) who, by all accounts have made disastrous economic decisions in the past, leading to the predicament we are now in. Many people can rightfully recognize that the "bailout mania" creates an ever-growing moral-hazard problem that will emerge in the future, given that the bailouts effectively socialize economic losses for those sectors of the economy deemed "too large to fail." Of course, the current bailouts, and resulting piling up of federal debt predict an inevitable increase in tax rates for everyone, especially high-income earners who undertake most of the country's savings. And the prospect of higher taxes can dampen incentives to work hard, save, and invest today for gains that can only be collected (and taxed) in the future.

The domestic automakers are now up for a bailout of \$34 billion (which could mount to more than \$125 billion with time as new bailout dollars are thrown after wasted dollars). Reluctant supporters argue that the bailout is a grand opportunity for our political leaders in Washington to guide domestic automakers into a revitalized future by conditioning the bailouts on the companies' adopting "green" car-development strategies. Good luck. With all the waste evident in government programs, it's hard to understand how our political leaders will manage

the domestic automobile industries any better than the current crop of poor managers in the executive suites of The Big Three, especially since, with the bailouts, the auto executives will be spending dollars of rationally ignorant taxpayers, not the dollars of investors who have at least some incentive to monitor what the executives do. Washington politicians and bureaucrats are unlikely to manage the automobile industry any better than they have managed the post office. At any rate, when companies are about to fold, long-term retooling requirements for the domestic auto industry can do little other than place in peril the companies' short-term survivability.

News reports constantly tout how hundreds of billions (maybe trillions) of dollars of new federal spending will "stimulate" the economy in some magnified way, all if by magic. The dollars the federal government spends will become income to those who sell goods and services (roads and bridges and hospitals) to the federal government. Those sellers will spend their added income on everything from high definition televisions to bread, with the expenditures becoming income to others – and so the economic chain reaction is said to spread. But few reports mention that the dollars spent on stimulus programs can't be pulled from magic lanterns. They must come from somewhere – and, necessarily, out of people's pockets. And those dollars coming out of people's pockets would almost all have been spent or invested, which means that stimulus packages have two effects: They pump dollars into identified sectors of the economy, but they also pull dollars from other sectors – and then the resulting additions to the federal deficits can give rise to expectations of higher tax rates in the future. Then, there is the claim that the economy needs a stimulus *now*, but major expenditures on major infrastructure projects can take years to plan and activate.

The stimulus packages might have a net positive effect, but they could just as easily have a net negative effect on the economy. And proponents of stimulus packages surely are guessing over what the net effect will be, or are simply responding to political pressure to "do something, anything" so long as critics of such policy courses don't have a clue about the net effect either.

From the time the current economic calamity showed its ugly head in late 2007, our political leaders, following the advice of their experts, have pointed to two causative forces:

- First and foremost, housing prices got way out of line after 2003 in response to "irrational exuberance" and "bubble thinking," which encouraged people to buy houses that were more than they could afford given their incomes and credit records (all encouraged by the advent of subprime and Alt-A mortgages).
- Second, in search of profits, banks and investors around the world bought tons of the mortgage-backed securities, both because they misjudged the tenuous nature of housing market bubble and because they were sold a bill of goods in the mortgage-backed securities. With the collapse of housing prices, investors can no longer trust security sellers because they might rightfully believe, in many cases, that they were defrauded and because the value of mortgage- and credit card-backed securities might deteriorate more with the declining economy and, hence, the credit worthiness of borrowers.

If inflated housing prices are at the heart of the current economic calamity, then the government is not a clear source of remedies, especially so-called remedies that seek to re-inflate housing prices or hold them close to their current levels. The obvious solution is one our political leaders find hard to accept: Let housing prices fall to where they are in line with people's abilities to buy and in line with their credit worthiness.

On the other hand, if lost confidence is at the heart of current problems, the government is unlikely to be able to rebuild its own integrity (which is hardly at an all-time high, especially now with a likely trillion-dollar budget deficit this fiscal year), much less rebuild the integrity of financial institutions by papering over or excusing their past bad decisions. Integrity is something that must be earned by honest repeated dealings with relevant others; business integrity (and confidence) simply can't be doled out from Washington.

As depressing and sad as it might be, the only viable fix for the economy might be an old-fashioned one and might only come with time, as out-of-line housing and other asset prices adjust and as people and businesses themselves rebuild their reputations from solid records of honest business dealings. But then, the recovery might come far quicker than our political leaders now believe, simply because current economic conditions have opened huge opportunities for investors to build up firms that never lost their way in the euphoria of the housing bubble, and to create new firms who seek the profits to be made from honest dealing and conservative risk-taking.

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